

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0202

Sales and Use Tax

For Tax Years 1993 through 1996

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ISSUES

I. Sales and Use Tax—Air Make-Up System

Authority: Cave Stone, Inc. v. State Department of Revenue, 457 N.E.2d 520 (Ind. 1983); General Motors Corporation v. Indiana Department of State Revenue, 578 N.E.2d 399 (Ind. Tax 1991); Indiana Department of State Revenue v. Amax, Inc., 513 N.E.2d 1260 (Ind. App. 1987); IC 6-2.5-5-3; 45 IAC 2.2-5-8

Taxpayer protests the assessment of use tax on its air make-up system.

II. Sales and Use Tax—Quality Control-Destructive Testing

Authority: 45 IAC 2.2-5-8

Taxpayer protests the assessment of use tax on its quality control destructive testing.

III. Sales and Use Tax—Coke Delivery System

Authority: 45 IAC 2.2-5-8(f)(1)

Taxpayer protests the assessment of use tax on its coke delivery system.

STATEMENT OF FACTS

Taxpayer is a manufacturer of steel castings for the automotive industry and has two manufacturing plants in Indiana. The Indiana Department of Revenue ("Department") conducted an audit investigation for the period beginning January 1, 1991 through April 30, 1993 and a separate sales and use tax audit for calendar years 1995-1996. One of the manufacturing plants was constructed during the sales and use tax audit period. Further information will be provided as necessary.

I. Sales and Use Tax—Air Make-Up System

DISCUSSION

Taxpayer protests assessment of use tax on an air make-up system. Taxpayer believes that the air make-up system is exempt from use tax because its primary purpose is to cool fluids which are used to cool exempt production machinery. The auditor disallowed the exemption of the air make-up system on the basis that its primary purpose was to ventilate the plant and that the primary purpose of piping the fluids through the air make-up system is to heat the air coming into the plant. The auditor expressed that cooling of fluids is only a secondary benefit, and then only during winter months.

The relevant statute is IC 6-2.5-5-3(b), which states:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

This is the so-called “double-direct” test. The courts have interpreted this to mean that the equipment in question must be “essential and integral” to an integrated production process. General Motors Corporation v. Indiana Department of Revenue, 578 N.E. 2d 399 (Ind. Tax 1991).

Taxpayer refers to several cases which it believes support applying the exemption to the air make-up system, including Cave Stone v. Indiana Department of State Revenue, 457 N.E.2d 520 (Ind. 1983); Indiana Department of Revenue v. Amax, Inc., 513 N.E.2d 1260 (Ind. App. 1987); and, General Motors. In Cave Stone, the taxpayer, a manufacturer of finished stone products, had been denied an exemption for trucks used to transport rock from a quarry to its processing plant. The trucks were essential and integral to the production of tangible personal property. The Supreme Court of Indiana explained in that case that, since no production could have occurred without the equipment in question, the equipment was exempt.

In Amax, the Indiana Court of Appeals held that equipment and supplies used to construct and maintain haulage roads was exempt due to the fact that production could not occur without roads to transport haulage trucks. In General Motors, the Indiana Tax Court held that the materials used to pack work-in-progress for transportation between plants were exempt as essential and integral to an integrated production process. All of these cases point to the need for the equipment in question to be essential and integral to the production process.

In this instance, the equipment in question was not essential and integral. There is a separate loop to cool the fluids outside during the summer months. The fluids are only

pipled through the air make-up system in the winter months. Certainly, if the outside cooling loop is effective enough to cool the fluids in the summer, when the outside temperatures are higher, then it would be effective enough to cool the fluids in the winter, when the outside temperatures are lower. The clear purpose of piping the fluids through the air make-up system in the winter is to capture the heat coming off of the pipes as the fluids are cooled, thereby warming the air coming into the plant.

Also, the air make-up system operates year-round, even when the fluids are pipled through the outside cooling loop. No heating of the plant occurs, yet the ventilation continues. Thus, the primary purpose of the air make-up system is not to cool fluids, but rather to ventilate the plant.

Taxpayer also argues that the air make-up system should be exempt as safety equipment. At the hearing, taxpayer expressed that the atmosphere in the plant became congested with dust and required ventilation from the air make-up system. 45 IAC 2.2-5-8(c)(2)(F) states that equipment required to allow workers to participate in the production process without injury is exempt. 45 IAC 2.2-5-8(c)(4)(B) states that equipment primarily for workers comfort and convenience is taxable. The taxpayer has presented no evidence that the air make-up system is required to allow its workers to participate in the production process without injury.

Since the air make-up system is not “integral and essential”, it does not pass the “double-direct” test. Also, since there was no documentation to establish the air make-up system as a safety requirement, it does not qualify for that exemption.

FINDING

Taxpayer’s protest is denied.

II. Sales and Use Tax—Quality Control Destructive Testing

DISCUSSION

Taxpayer protests the assessment of use tax on equipment and material used in testing during the production process. Taxpayer relies on 45 IAC 2.2-5-8(i), which states:

Testing and equipment. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

-EXAMPLE-

Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated process and is exempt.

Taxpayer explains that some castings are selected for testing and undergo several quality control tests during the production process. The samples are tested for hardness, using cutting tools and polishing tools. If the samples meet specifications, production continues. If the samples do not meet specifications, alterations are made to the production process to improve the product. After testing, the castings are remelted and incorporated into new castings produced for sale. Given the taxpayer's method of sampling (in-process) and the functional interrelationship between the testing equipment and the machinery on the production line, the Department finds that the testing is part of the integrated production process.

FINDING

Taxpayer's protest is sustained.

III. Sales and Use Tax—Coke Delivery System

DISCUSSION

Taxpayer protests assessment of use tax on equipment used to transport coke from storage to an exempt furnace. The auditor assessed the equipment as a pre-production item, per 45 IAC 2.2-5-8(f)(1).

45 IAC 2.2-5-8(f)(1) states:

Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

Taxpayer characterizes the coke delivery system as part of an integrated process, including computerized temperature monitoring and automated feeding of coke to the furnaces, without which production could not take place. The Department characterizes the system as raw material delivery. The transportation of raw materials into the production process, using pharmaceutical manufacturing as an example of an integrated production process, is discussed in 45 IAC 2.2-5-8(d)(1).

45 IAC 2.2-5-8(d)(1) states:

The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. *Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable.* Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for exemption. Equipment which loads packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax. (Emphasis added.)

The Department finds that no weighing and measuring of appropriate ingredients is involved here, therefore the coke delivery system is part of the pre-production process. The system merely transports the coke from storage to the furnace. The raw material has not yet entered into the production process.

FINDING

Taxpayer's protest is denied.

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